The Growth of Real Estate Debt Funds: Latest Trends

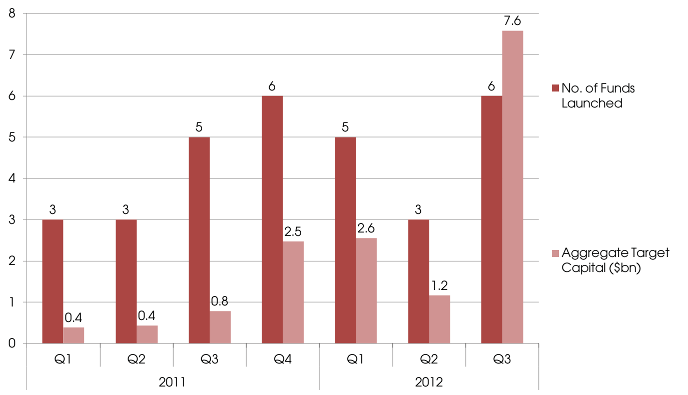
With an increasing number of real estate debt funds being launched, Andrew Moylan takes a look at this growing sector and the prospects for real estate debt funds in the future.

With traditional bank financing for real estate remaining hard to come by, many fund managers have spotted an opportunity in the market; as a result there are an increasing number of real estate debt funds being launched to help fill this gap. Many firms are diversifying their businesses to include specialist debt platforms, while a growing number of fund managers are incorporating debt investments into their existing investment strategies. Institutional investors are also increasingly seeing the value that real estate debt can bring to their existing real estate portfolios, with a growing number expecting to commit to real estate debt offerings in the coming year.

The number of new debt funds coming to market demonstrates the increased importance of debt within the market as a whole. The first three quarters of 2012 saw 14 debt funds begin fundraising, with an aggregate target of $11.4bn, but there was a particular increase in Q3. The $7.6bn targeted by debt funds launched in Q3 2012 alone is almost double the aggregate target of all debt funds launched in 2011. Debt funds accounted for 59% of $13.5bn targeted by private real estate funds which began fundraising in Q3 2012. Already in Q4 2012, we have seen more debt funds come to market. ICG-Longbow has commenced fundraising for its ICG-Longbow UK Real Estate Debt Investments III, which has a £500mn target, while Balmain Investment Management is seeking AUD 500mn for its Australia-focused Secured Private Debt Fund.

There were also a number of notable debt funds launched during Q3 2012. Blackstone Group began fundraising for Blackstone Real Estate Debt Strategies II, which has a $4bn target and focuses primarily on high yield lending on commercial real estate, while AXA Real Estate is targeting €1bn for its second European senior loan fund CRE2. M&G Investments launched two debt funds in the quarter: M&G Real Estate Debt Fund II focuses on mezzanine debt while M&G Real Estate Debt Fund III targets senior loans.

Fig. 1: Real Estate Debt Funds Launched, Q1 2011 - Q3 2012



Source: Preqin Real Estate Online

There are currently a total of 41 solely debt-focused real estate funds in market, with an aggregate target of $20.5bn. Solely debt-focused funds account for 13% of capital targeted by real estate funds on the road, with the largest funds in market shown in Fig. 2.

Growing Demand

Prior to the economic downturn, debt funds represented a small part of the real estate fund industry, but their importance has grown considerably in recent years. Before the financial crisis, real estate

Fig. 2: Largest Solely Debt-Focused Real Estate Funds in Market

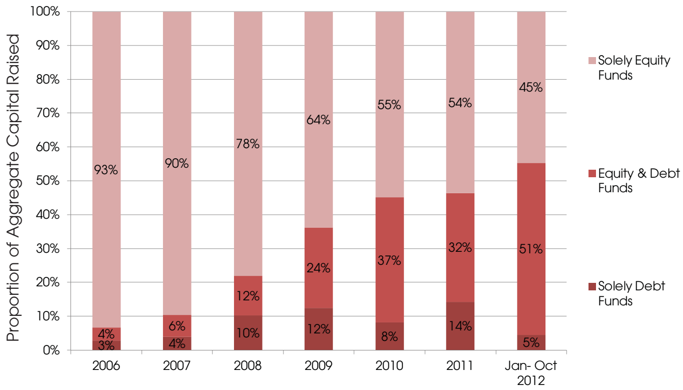
Fund	Firm	Target (mn)
Blackstone Real Estate Debt Strategies II	Blackstone Group	4,000 USD
Fortress Japan Opportunity Fund II	Fortress Investment Group	100,000 JPY
CRE2	AXA Real Estate	1,000 EUR
Torchlight Debt Opportunity Fund IV	Torchlight Investors	1,000 USD
Henderson Senior Secured Real Estate Debt Fund	Henderson Global Investors - Property	500 GBP
M&G Real Estate Debt Fund II	M&G Investments	500 GBP
M&G Real Estate Debt Fund III	M&G Investments	500 GBP
ICG-Longbow UK Real Estate Debt Investments III	ICG-Longbow	500 GBP
H/2 Special Opportunities II	H/2 Capital Partners	750 USD
Mesa West Real Estate Income Fund III	Mesa West Capital	650 USD
Senior European Loan Fund	AEW Europe	500 EUR

Source: Preqin Real Estate Online

equity funds were able to deliver very strong returns, something which would be much harder to achieve in the current financial environments seen in the US or Europe. With financing from traditional lenders much scarcer, many fund managers saw the opportunity to generate returns by investing in real estate debt.

As Fig. 3 illustrates, 93% of capital raised in 2006 was by funds focusing solely on equity. In subsequent years the proportion of capital raised that is account for by funds making debt investments has increased significantly. In 2009, 12% of capital was raised by solely debt funds, with a further 24% of capital raised by funds making a combination of debt and equity investments. In 2011, a total of $8bn was raised by funds focusing on debt investments, which represented 14% of all capital raised in the year. Notable funds to close last year included the $2.9bn Blackstone Real Estate Special Situations Fund II and AXA Real Estate's €1bn CRE Senior 1. While less capital has

Fig. 3: Annual Closed-End Private Real Estate Fundraising, 2006 - October 2012: Equity vs. Debt



Source: Preqin Real Estate Online

Fig. 4: 10 Largest Real Estate Debt Funds Closed, 2011 - 2012

Fund	Firm	Size (mn)
Blackstone Real Estate Special Situations Fund II	Blackstone Group	2,900 USD
CRE Senior 1	AXA Real Estate	1,000 EUR
Pramerica Real Estate Capital I	Pramerica Real Estate Investors	492 GBP
Prudential U.S. Real Estate Debt Fund	Pramerica Real Estate Investors	805 USD
Colony Distressed Credit Fund II	Colony Capital	780 USD
M&G Real Estate Debt Fund	M&G Investments	494 EUR
European Real Estate Debt Fund	DRC Capital	300 GBP
Contrarian Distressed Real Estate Debt Fund II	Contrarian Capital Management	450 USD
Longbow UK Real Estate Debt Investments II	ICG-Longbow	242 GBP
Cornerstone Enhanced Mortgage Fund	Cornerstone Real Estate Advisers	315 USD

Source: Preqin Real Estate Online

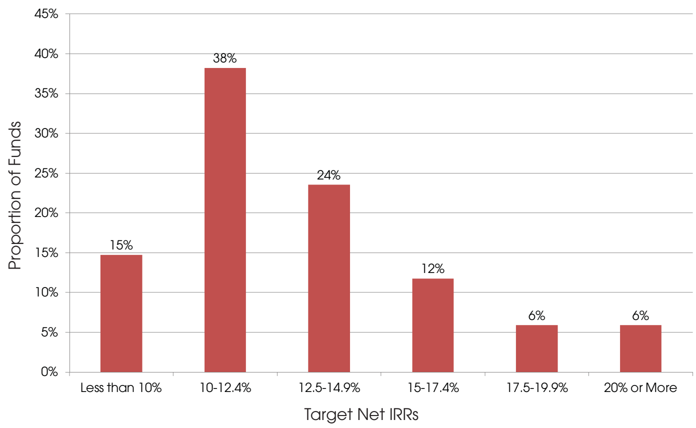
been raised for specialist debt funds in 2012 to date, the proportion of capital raised by funds which incorporate debt investments as part of their strategy has increased. Fifty-six percent of capital raised in the period January to October 2012 was by funds which are making debt investments to some extent.

The largest solely debt-focused funds to close since 2011 are shown in Fig. 4. Pramerica Real Estate Investors held a final close on $805mn for its Prudential U.S. Real Estate Debt Fund at the end of September 2012. The firm has also raised £492mn for its Europe-focused debt fund Pramerica Real Estate Capital I.

Targeted Returns

There is an increasing diversity of returns targeted by real estate debt funds, a reflection of the range of differing risk exposures offered by this strategy. Much of the appeal of debt funds comes from their opportunity to deliver strong returns, with a lower level of risk than a fund targeting equity investments. The breakdown of net IRRs targeted by real estate debt funds which are currently in market or have closed since 2011 is shown in Fig. 5. Funds with a net IRR target of 10-12.4% represent the largest proportion of these funds, with 36% falling into this bracket. A further 24% of funds are targeting net IRRs of 12.5-14.9%. These funds are targeting IRRs in the core-plus to value added range, but will be hoping to convince investors they can deliver these returns with a lower level of risk.

Fig. 5: Target Net IRR Distribution of Real Estate Funds in Market and Funds Closed, 2011 - 2012



Source: Preqin Real Estate Online

Fifteen percent of these funds are targeting IRRs of less than 10%, with these funds typically focused on senior loans. Some investors may see these funds as more akin to a fixed income investment than a real estate one. The 24% of funds which are targeting IRRs of 15% or more, which would typically associated with opportunistic investments, are frequently targeting distressed debt in order to secure these levels of returns.

Fig. 6: Sample Investors Investing in Real Estate Debt Funds

Investor	Location	Future Plans
Local Insurance Mutual Company	Finland	Plans to invest in Europe-focused real estate debt funds in the next 12 months.
Missouri Local Government Employees Retirement System	US	Expects to commit to US-focused debt funds in the next year.
Samsung Life Insurance	South Korea	Looking to increase its private real estate fund investments over the next 12 months and is particularly interested in real estate debt funds focusing on Europe, North America or Australia.
San Francisco City & County Employees' Retirement System	US	Has targeted $400mn to non-core real estate funds; the pension fund is particularly interested in debt.
HESTA	Australia	Looking to make new commitments to private equity real estate funds over the next 12 months. It invests globally and is particularly interested in real estate debt funds.

Source: Preqin Real Estate Online

Investor Interest Real Estate Debt Funds

There has been a significant increase in appetite for real estate debt funds in the past year. Of the investors expecting to make investments in the coming 12 months, 23% are targeting debt funds, up from just 8% in Q4 2011. In comparison, appetite for other real estate strategies has remained fairly consistent. Fifty-three percent of active investors are targeting core funds, an increase of six percentage points from Q4 2011, while 44% are targeting opportunistic investments, up from 42% in Q4 2011. Value added strategies are also targeted by 44% of investors, a three percentage point fall from Q4 2011.

Though debt funds are only attracting interest from just under a quarter of real estate investors, it is clear that an increasing number of institutions are looking at opportunities in the sector. As shown in Fig. 6, there are a number of investors which are focusing on real estate debt funds.

Outlook

Debt has evolved from a niche segment of the real estate fund market, into a central part of the industry with more than half of all funds closing in 2012 investing in debt to a greater or lesser extent. The launch of a number of large debt funds in the third quarter of the year suggests that this is unlikely to change, with fund managers increasingly looking to build debt platforms to take advantage of the shortage of bank lending within the real estate market. While many investors are yet to consider the sector, an increasing number are looking to invest in real estate debt and it seems likely that more will examine these opportunities in greater depth in the coming months.

